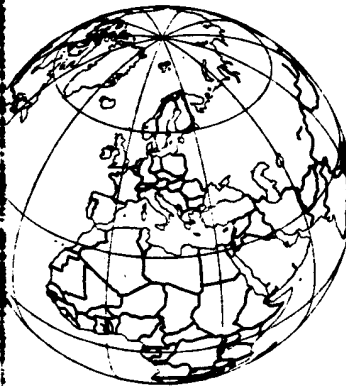


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==== **Director,** =====
E U R A
Office of European Analysis
Directorate of Intelligence

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Central Intelligence Agency



Washington, D.C. 20505

26 February 1986

MEMORANDUM FOR: Mr. Lucien Pugliaresi
Director for International Economics
National Security Council

FROM : [redacted]
Office of European Analysis

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SUBJECT : Impact of Oil Price Companies

In response to your request of 25 February, I am forwarding a copy of the report I wrote describing our estimates of the impact of oil prices falling to \$20 or \$15 per barrel. These estimates depend on a series of assumptions described in the text. If you would like to change any of the assumptions and have some alternative scenarios analyzed, or if you have questions about these results, please call [redacted]

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Attachment: as stated

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OECD: Estimated Impact of an Oil Price Collapse

A plunge in world oil prices from the current level of \$26.50 to \$20 or so would boost OECD economic growth and lower inflation significantly. We estimate that, compared to a baseline scenario assuming a constant oil price of \$26.50, \$20 oil would boost the OECD real GNP growth rate by 0.4 percentage point in 1986, 0.8 percentage point in 1987, and 0.3 percentage point in 1988. Inflation would fall about one percentage point in both 1986 and 1987. Employment in the OECD would rise over two million over the three-year period. The impact of an even greater fall in the price of oil to \$15 a barrel would be roughly twice as stimulative.

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Table 1

**Change in Real GNP Growth Rates
\$20 a barrel oil vs. \$26.50, 1986-88**

	1986	1987	1988
OECD	0.4	0.8	0.3
United States	0.7	1.4	0.6
Non-US OECD	0.3	0.6	0.2
Canada	0.3	0.6	0.4
Japan	0.6	0.1	-0.1
Western Europe	0.0	0.4	0.3
Big Four	0.0	0.5	0.3
West Germany	0.1	0.6	0.4
France	0.1	0.2	0.4
United Kingdom	-0.6	0.6	0.0
Italy	0.3	0.5	0.3
Other OECD	0.2	0.1	-0.1

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Lower oil prices would improve OECD growth in several ways:

- * A sharp drop in oil prices to \$20 a barrel would leave well over \$100 billion in the hands of OECD consumers businesses between now and 1988. Most of this money would be spent on OECD produced goods and services.
- * The favorable impact on inflation would further increase real purchasing power, as declines in wage rate increases lag the fall in inflation and as lower current inflation induces consumers to spend a larger proportion of their income.
- * Lower inflation rates also would help reduce nominal rates thus stimulating investment.

Set against these favorable impacts would be lowered purchases by oil-exporting countries. We are not sure how great these cuts would be, but given the difficult financial position of most oil exporters, import cuts could be almost as great as revenue declines. This offset, however, would by no means outweigh the favorable impact on OECD growth.

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Among the OECD countries the United States would be the biggest gainer and the United Kingdom the biggest loser. The US oil import bill--GNP and oil import volume held constant--would fall about \$15 billion. This reduction, plus the stimulus provided by lower inflation and lower interest rates, would boost private consumption of domestic goods and private investment. The US current account balance would improve by \$8 to 10 billion in 1986, somewhat less than the fall in the oil import bill because import volume--both fuel and non-fuel-- would rise and export volume would fall.

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The West European countries as a group would gain much less than the United States, with no gain in real GNP growth in the first year of the oil price collapse, and a 0.4 percentage point gain in the second year. The United Kingdom, a large net oil exporter, would be hurt the first year as lower export revenues more than offset the positive stimulus of lower inflation and nominal interest rates, even if, as we assume here, the British Government does not cut back its expenditures in the face of a large decline in revenues from oil. The UK economy would probably rebound in the second year of \$20 oil because increased exports to the rest of the OECD and increased investment stimulated by lower interest rates would outweigh the adverse effects of lower oil prices.

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The boost to real GNP in West Germany, France, and Italy would be significant. They would gain less than the United States, though, partly because their exports to the oil-exporting countries (whose imports would fall) make up a larger share of total exports, and partly because--due to tax policies and price rigidities--falls in oil import prices result in smaller declines in the overall price level. After three years these three countries would enjoy real GNPs of three quarters to a full percentage point higher than the baseline estimate assuming \$26.50 oil. Employment would increase modestly under these conditions, and unemployment rates would fall by about 0.3 percentage point--after three years--in each of these three countries.

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Canada--although a net oil exporter--would gain significantly from a drop in world oil prices. Its loss in oil export revenues would be more than offset by gains in non-fuel exports to the United States and by the positive impact of lower domestic inflation.

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Japan would also gain sharply in the first year of an oil price decline. Its already huge current account surplus would increase by another \$8 billion or so.

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The smaller OECD countries as a group would gain less than the OECD average, partly because net oil imports constitute a smaller share of GNP than they do for the rest of the OECD, and partly because exports to

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[REDACTED]

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OPEC constitute a higher share of total exports. Some individual countries, such as Turkey and Greece, which rely on exports to the Middle East, and oil-exporting Norway, would probably be hurt by an oil price collapse, at least in the short run. [REDACTED]

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The model also estimates that the non-OPEC LDCs, as a group, would benefit from an oil price decline, especially in the second and subsequent years of the price cut. The estimated decline in interest rates in the United States would reduce the aggregate LDC current account deficit more than the decline in the oil import bill. [REDACTED]

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[REDACTED]

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Methodology and Assumptions

The quantitative estimates of the economic impact of fall in oil prices are based on simulations with the CIA's Linked Policy Impact Model (LPIM) of the world economy

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In utilizing this model, the effects of a drop in the world oil price were calculated holding most policy variables unchanged. The key assumptions:

- * The baseline scenario assumed that real GNP growth in the OECD will average 3 percent a year, 1986-88, and the average price of internationally traded crude petroleum will equal \$26.50 a barrel.
- * Assuming a plunge in oil prices to \$20 a barrel on 1 January, 1986, we assumed that OECD governments kept overall public consumption and investment unchanged in real terms from the baseline projections. We assumed no new energy taxes or changes in energy tax rates. We also assumed that the monetary authorities in each country kept the money base unchanged, but that the money supply rose somewhat (except in the United Kingdom and Canada where declines in nominal income were accompanied by a decline in the supply of money). These assumptions led to falling nominal interest rates in all OECD countries.
- * The LPIM estimates that the OPEC countries, faced with a huge price decline, would cut imports by about two-thirds of the revenue loss over a three-year period. Thus, their aggregate current account deficit would worsen by \$20, \$10, and \$5 billion in 1986-88, respectively. The OECD results are sensitive to OPEC behavior. If OPEC were forced to cut imports by 85 percent of the revenue loss, the estimated OECD improvement in real GNP would be only 0.2 percent in 1986.
- * Exchange rates were not held constant in these model simulations, but they changed only slightly in response to modest changes in relative prices and interest rates among the OECD countries. It was assumed that no large changes in expectations would occur to cause large swings in the value of one currency or another.

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**LINKED MODEL PROJECTIONS
DEVIATIONS FROM BASELINE**

BASELINE SCENARIO WITH \$26.50 OIL, ALTERNATIVE SCENARIO WITH \$20 OIL

1986

	REAL GDP GROWTH	BALANCE OF PAYMENTS	INFLATION RATE: CPD	UNEMPLOYMENT RATE
US	+0.7	+7.8	-1.1	+0.2
CANADA	+0.3	-0.9	-1.6	+0.1
JAPAN	+0.6	+8.1	-0.6	-0.0
UK	-0.6	-3.5	-1.4	+0.2
FRANCE	+0.1	+2.8	-0.9	-0.0
GERMANY	+0.1	+0.4	-0.3	-0.0
ITALY	+0.3	+2.9	-1.1	-0.1
BIG 4	-0.0	+2.6	-1.0	-0.0
OTHER OECD	+0.2	+7.2	-0.4	-0.0
WEST EUROPE	+0.0	+9.1	-0.8	+0.0
OECD	+0.4	+24.8	-0.9	+0.1

1987

	REAL GDP GROWTH	BALANCE OF PAYMENTS	INFLATION RATE: CPD	UNEMPLOYMENT RATE
US	+1.4	+1.0	-1.6	-0.6
CANADA	+0.6	-1.2	-0.8	+0.1
JAPAN	+0.1	+5.9	-0.1	-0.0
UK	+0.6	-5.3	-1.0	+0.2
FRANCE	+0.2	+1.3	-0.5	-0.1
GERMANY	+0.6	+0.8	-0.5	-0.1
ITALY	+0.5	+2.9	-0.4	-0.2
BIG 4	+0.5	-0.2	-0.5	-0.3
OTHER OECD	+0.1	+5.9	-0.7	-0.1
WEST EUROPE	+0.4	+5.1	-0.6	-0.1
OECD	+0.8	+11.4	-1.0	-0.2

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1988

	REAL GDP GROWTH	BALANCE OF PAYMENTS	INFLATION RATE: CPD	UNEMPLOYMENT RATE
US	+0.6	-2.6	-0.9	-1.0
CANADA	+0.4	-1.1	-0.9	+0.1
JAPAN	-0.1	+4.2	-0.1	-0.0
UK	-0.0	-6.9	-0.4	+0.1
FRANCE	+0.4	+1.6	-0.2	-0.3
GERMANY	+0.4	+1.2	-0.3	-0.3
ITALY	+0.3	+3.0	-0.3	-0.4
BIG 4	+0.3	-1.1	-0.3	-0.6
OTHER OECD	-0.1	+4.1	-0.4	-0.1
WEST EUROPE	+0.2	+2.5	-0.3	-0.2
OECD	+0.3	+3.4	-0.5	-0.4

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**LINKED MODEL PROJECTIONS
DEVIATIONS FROM BASELINE**

BASELINE SCENARIO WITH \$26.50 OIL, ALTERNATIVE SCENARIO WITH \$15 OIL

1986

	REAL GDP GROWTH	BALANCE OF PAYMENTS	INFLATION RATE: CPD	UNEMPLOYMENT RATE
US	+1.3	+14.0	-1.9	+0.3
CANADA	+0.6	-1.6	-3.0	+0.2
JAPAN	+1.0	+14.3	-1.0	-0.1
UK	-1.2	-6.3	-2.5	+0.4
FRANCE	+0.2	+5.0	-1.7	-0.0
GERMANY	+0.1	+0.8	-0.6	-0.0
ITALY	+0.5	+5.1	-2.0	-0.1
BIG 4	-0.1	+4.5	-1.8	-0.0
OTHER OECD	+0.3	+12.7	-0.8	-0.1
WEST EUROPE	+0.0	+15.9	-1.5	+0.0
OECD	+0.7	+43.9	-1.7	+0.1

1987

	REAL GDP GROWTH	BALANCE OF PAYMENTS	INFLATION RATE: CPD	UNEMPLOYMENT RATE
US	+2.9	+2.2	-2.9	-1.2
CANADA	+1.1	-2.0	-1.5	+0.2
JAPAN	+0.2	+10.7	-0.2	-0.1
UK	+1.0	-9.6	-1.9	+0.4
FRANCE	+0.4	+2.5	-1.0	-0.2
GERMANY	+1.0	+1.7	-1.0	-0.2
ITALY	+1.0	+5.4	-0.8	-0.4
BIG 4	+0.9	-0.2	-1.1	-0.5
OTHER OECD	+0.2	+10.8	-1.4	-0.1
WEST EUROPE	+0.7	+9.6	-1.2	-0.1
OECD	+1.6	+21.5	-1.8	-0.5

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1988

	REAL GDP GROWTH	BALANCE OF PAYMENTS	INFLATION RATE: CPD	UNEMPLOYMENT RATE
US	+1.4	-6.7	-1.5	-2.1
CANADA	+0.9	-1.8	-1.7	+0.1
JAPAN	-0.1	+8.6	-0.2	-0.1
UK	-0.0	-12.4	-0.7	+0.2
FRANCE	+0.7	+3.3	-0.3	-0.5
GERMANY	+0.8	+2.4	-0.6	-0.6
ITALY	+0.6	+5.6	-0.6	-0.8
BIG 4	+0.5	-1.0	-0.5	-1.0
OTHER OECD	-0.0	+8.1	-0.6	-0.1
WEST EUROPE	+0.4	+6.3	-0.6	-0.3
OECD	+0.8	+7.2	-1.0	-0.9

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